ACTEX Learning

Study Manual for Retirement Benefits Design & Accounting US Exam

2nd Edition

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An SOA Exam

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RETIREMENT PLANS (12^{TH} EDITION) BY ALLEN ET AL

Chapter 2: Strategic Plan Design

I. ENVIRONMENTAL CONSIDERATIONS

1. Tax Equity and Fiscal Responsibility Act TERFA (1982)
   a) Before: ER legal tax status (e.g. sole proprietorship, partnership, corporations) influenced plan design
   b) After: Eliminated most distinctions in tax laws
2. Section 501(c) (3) organizations
   a) Contributions not tax deductible
   b) Higher cost for EE benefits than profit-making corporations
   c) DC concepts more common (Section 403(b) tax-deferred annuity can be used)
3. Background for designing EE benefit program
   a) Characteristics of ER, Industry and Workforce
   b) Local communities
      i) More important if ER is a dominant ER (type of image ER wants to project)
   c) Presence of collective bargaining units
   d) For ER with diversified operations, also consider
      i) Is the same benefit program is appropriate for all?
      ii) ER attitude towards EE transfer

II. EMPLOYER PHILOSOPHY AND ATTITUDES

1. ER basic compensation philosophy (Compensation strategy)
   a) Cost and benefit structure of benefit plans reflect attitude towards other compensation elements
      i) ER with policy of high wages, also have liberal benefit programs
   b) Keep total compensation at acceptable level but stress more on certain element
      i) High wages but only modest benefit
      ii) Affect turnover; attract certain EE
   c) Reverse compensation strategy (Common in public sector)
      i) Liberal benefits but only modest wages
2. ER basic attitude towards providing EE benefits (2 basic approaches)
   a) #1: Income maintenance approach (in event of economic insecurity)
      i) E.g. DB plan integrated to maximum extent with Social Security
      ii) E.g. Death benefit provides income only to survivors of EE immediate family
   b) #2: Compensation oriented approach (E.g. DC plans)
3. Does ER believe EE should share the cost?
   a) If yes, common form is EE contributions or lower benefits
   b) From perspective of total EE benefit program, can be a mix of contributory / non-contributory plans, as long as over EE contribution level is reasonable
4. ER attitude towards who (ER / EE) should bear inflation and investment risk in long-term, advance-funded retirement program
   a) Affect choice of DB or DC plans
5. ER attitude towards retirement pattern through selection of specific provisions
   a) Retirement ages (Normal / Early) and subsidies
   b) Deferred retirement
   c) Postretirement life and medical expense insurance

6. ER attitude towards providing EE choice and control over plan participation
   a) If yes: Flexible / cafeteria benefits (before tax credits) or layers of after-tax contributory coverage
   b) If no: due to paternalistic nature or associated high cost for offering flexibility
7. ER position towards cost commitment (both current and future cost level)
   a) Affect benefit levels and ancillary benefits
8. ER attitude towards co-ordination with Social Security benefits
   a) If yes: More equitable balancing of costs and benefits for all pay levels
   b) If no: due to communication and administration difficulties
9. ER attitude towards different benefits program for executives from rank-and-file
   a) If yes: due to executive needs not met by plans which satisfied non-discrimination requirement
   b) If yes, ER also provide additional death and disability benefits
10. ER willingness to assume plan termination obligations
    a) Can affect company's net worth, credit ratings and capital raising, also pay insurance premium
    b) If no: DC plans

III. <u>EMPLOYER OBJECTIVES</u>

1. Attract and retain EE
   a) Some benefit plans may have greater impact than others on EE
      i) E.g. EE may find Employer A's generous profit sharing plan more attractive than Employer B's more conventional pension
2. Meet competitive standards
   a) Reflect ER attitudes about own standing in industry and communities
   b) EE benefit plans highly visible and readily subject to external comparison
   c) Step 1: Must establish comparison standards
      i) Vs. industry standards (if EE skills are less transferrable)
      ii) Vs. local companies (if EE skills are more transferrable)
   d) Step 2: Decide upon the desirable level of competitiveness (e.g. leader, average)
   e) Step 3: How to establish the desired relative standing of different plans
      i) Compare actual benefits payable to representative EE under different situations
         ➔ Caution 1: Do not give true relative cost of plans
         ➔ Caution 2: Do not account for other benefits in the same plan
         ➔ Caution 3: Sensitive to assumptions used for illustrations
      ii) Compare actual ER costs for different benefit plans
         ➔ Caution 1: Inconsistent reporting among different ERs
         ➔ Caution 2: Actual contribution pattern may not be indicative of real cost
      iii) Focus on relative value of different benefits by establishing value of specific plans, specific benefits within plan and aggregate value (use uniform actuarial methods and assumptions)
      ➔ Caution 1: Does not establish actual costs or cost patterns
3. Cost considerations
   a) Position on ultimate real cost and estimated annual costs (e.g. benefit levels)
   b) Need for contribution flexibility
   c) Position on expected cost from future inflation (e.g. career-pay formula, DC/DB)
   d) Need for cost-efficient retirement program
      i) Co-ordinate benefits from all sources
   e) Use retirement plan as tax shelter for key personnel
      i) Max. benefits and contribution within federal tax law
4. Legal compliance (ER has choice over how compliance is achieved)
   a) Age Discrimination in Employment Act (ADEA)

        i) Prevents discrimination against EE 40+
        ii) Does not require all benefits plans to treat all EE alike regardless of age
    b) Federal tax law allows DB plan to exclude EE < age 21 or < 1 year of service
        i) ER may include all EEs or exclude maximum number possible
    c) Nondiscrimination requirement
        i) ER desires different pay definition for executives and rank & file in DB plan
        ii) Fail nondiscrimination requirement – No qualified status
        iii) ER can have a qualified plan with nondiscriminatory pay definition and a SERP that applies base plan formula to incentive pay
    d) SEC requires only registered savings plan can invest EE contribution in ER securities
        i) Avoided if ER securities only purchased with ER contributions

5. Achieving optimum tax benefits
    a) May affect other benefits and how they are funded
6. Efficiency of design
    a) Recognize some plans are primary and some are secondary
        i) E.g. ER pension plan is primary retirement plan, SS is an additional source
    b) Co-ordinate benefits from all sources to ensure overall in line with ER objectives
7. Income replacement ratio
    a) Critical in design of disability income and retirement plan (specific benefit formula)
    b) To set income replacement objectives
        i) Factor in EE own Social Security benefits
        ii) Higher objectives for lower paid EE
        iii) Use year(s) of salary closest to retirement years
        iv) Full income objectives only for EEs who completed a "career" of employment with ER (Reduced for EE with less service)
8. Other objectives
    a) Social obligations
    b) EE incentives (absence of benefit plans is negative influence)
    c) Corporate identification
    d) Administration ease

RETIREMENT PLANS (12TH EDITION) BY ALLEN ET AL

Chapter 3 Defined Contribution versus Defined Benefit Plans

I. BEFORE ERISA – DB PLANS PREVALENT

1. DB plans can accommodate income-replacement objectives of ER
2. Easier to integrate DB with Social Security benefits
3. DB plans more efficient at providing death and disability income
4. More equitable allocation of ER contribution under DB plans
5. DB plan protect EE against preretirement inflation
6. ER assumes investment risk (and rewards)
7. Termination benefits more costly for DC plans

II. ADVANTAGES OF DC PLANS

1. Flexible cost commitment
2. Still can increase EE productivity
3. Greater ER identification (if invest in ER security)
4. Greater EE relation value if young workforce
5. DC EE contribution on pre-tax basis (except money purchase plans)
6. Lower plan administration costs
7. No plan termination insurance premium

III. LEGISLATIVE FACTORS – DECLINE OF DB PLANS

1. ERISA
   a) Significant ER liabilities if plan terminated with insufficient assets
   b) ER subject to a lien favoring PBGC
2. Multiemployer Pension Amendment Act
   a) Substantial liabilities if ER withdraws from a multiemployer plan with unfunded vested liabilities
3. Federal government tax laws
   a) Encourage tax-deferred annuities for educational and other nonprofit entities
   b) Basic structure of IRC strongly oriented towards DC plans
   c) Following operates on DC approach
      i) Individual retirement arrangement (IRA) concept
      ii) Simplified employee pension (SEP)
      iii) Savings incentive match plans for EEs of small ERs (SIMPLE plans)
      iv) Qualified Roth contributions program
      v) Employee stock ownership plans (ESOPs)
      vi) Flexible benefit plans permit EE choice of welfare benefits, cash, deferred profit sharing or savings plan benefits
   d) ER extensive use of salary reduction arrangement under Section 401(k) cash / deferred profit sharing or savings plans
   e) Simpler plan design (E.g. Lack of joint and survivor provisions)

IV. OTHER FACTORS – DECLINE OF DB PLANS

1. Indirect effects from other legislation
   a) Plan design mainly predicated on co-ordination of private pension and Social Security benefits
   b) Social Security NRA
      i) Retirement over a wider age range now
      ii) Hard to maintain current plan design structure
      iii) Force ER to rethink design and delivery of retirement benefits
      iv) E.g. DC plans, non-integrated plans

Retirement Plans (12th edition by Allen et al)

Chapter 6 Profit Sharing Plans and Money Purchase Plans

I. COVERAGE REQUIREMENTS

1. PSP must be for the **exclusive benefit** of employees or their beneficiaries
2. Will not qualify if discriminate in favor of highly compensated employees
   a) Can restrict coverage by employment type as long as no prohibited discrimination
3. Few PSPs have minimum age requirement, but almost all have a service requirement
4. IRC permits a minimum age of 21 and a service requirement of up to one year
   a) Two years if plan has full immediate vesting and is not a cash or deferred arrangement

II. CONTRIBUTION REQUIREMENTS

1. IRC does not require that a PSP have a **definite predetermined contribution formula**
2. Also, contributions need not be based on profits
3. However, require that **substantial and recurring contributions** be made in order to meet requirement of plan permanency
4. Contributions can be made on discretionary basis or in accordance with a predetermined formula
5. Discretionary approach obviously offers flexibility of contribution level
   a) Also avoids possibility that contribution will exceed the amount deductible for federal income tax purposes
   b) Plan often will have minimums and maximums
6. On the other hand, some advantages of using a predetermined formula include:
   a) Promotes increased employee morale and security
7. With either approach, management must still decide the extent to which employees are to directly or indirectly share in the firm's profits
8. Management should take into account:
   a) Plan objectives
   b) Nature of the firm's business
   c) Pattern of profits
   d) Age and service demographics of employees
9. Contribution commitment is usually expressed as a fixed percentage of profits
   a) May be a sliding scale instead
10. Often there is a limitation on the amount of annual contributions
    a) One reason is to give a minimum rate of return on capital for stockholders

III. EMPLOYEE CONTRIBUTIONS

1. Conceptually illogical to require employee contributions under PSPs
2. In those plans that require employee contributions, the employer's contribution is usually based on the amount of employee's contributions
   a) Contributory plans are referred to as thrift or savings plans instead of as a PSP
3. Common to permit employee contributions on a voluntary basis
4. Voluntary contributions may be made as **elective deferrals** under Section 401(k) or as contributions from after-tax income

IV. ALLOCATIONS TO EMPLOYEE ACCOUNTS

1. Plan must have a definite **allocation formula** to be qualified
2. Therefore, need a way to determine how much to credit to each participant's account
3. Usually, this is done on the basis of compensation or a combination of compensation and service
4. Example of combination is that a unit of credit is given for a year of service or for $100 of compensation
   a) Then an employee's allocation is a prorata amount based on his credit to the credit of all participants
5. Vast majority though use only compensation as the allocation base
6. IRS needs the allocation formula to determine if plan meets the nondiscrimination requirements
7. If PSP allocates on the basis of a uniform percentage of pay and the same vesting schedule and definition of service applies to all participants, then plan will be deemed to meet the nondiscrimination requirements
   a) Plans having an integrated allocation formula that meets the permitted disparity rules of Section 401(l) will be considered to have a uniform minimum percentage allocation formula
8. If allocation formula is weighted for age and/or service and for units of pay that do not exceed $200, the plan will meet nondiscrimination requirements if the average of the allocation rates for highly compensated employees ("HCEs") does not exceed the average of the allocation rates for the non highly compensated employees ("NHCEs")
   a) Otherwise, plan is required to meet the tests of Section 401(a) (4)
9. Allocation formula is used to determine the employee's share of contributions for record-keeping purposes
   a) Contributions are not necessarily segregated on behalf of each participant
   b) Contributions are usually invested by the trustee as unallocated assets
   c) Exception is where the trust permits each participant's account to be invested in "earmarked" investments (e.g. where each participant can direct his or her own investments)
10. Allocation of employer contributions is subject to the contribution and benefit limitations of the IRC
11. As stated earlier, non-vested terminations result in forfeited amounts, which can be used:
    a) To reduce employer contributions, or
    b) Reallocated among the remaining participants (more typical in PSPs)
       i) Generally in proportion to pay
       ii) IRS prohibits reallocations based on the account balances of those remaining if doing so result in discrimination in favor of HCEs
12. Investment income, however, can be allocated based on account balances
13. Possible to have different allocation formulas for contributions, forfeitures, and investment income

V. INTEGRATION WITH SOCIAL SECURITY

1. PSPs are not usually integrated with Social Security
2. No portion of a plan that consists of a cash or deferred arrangement (CODA) may be integrated
3. Maximum deductible amount that can be allocated to each participant applies to the total of employer contributions and forfeitures during the year
4. For non-integrated plans, has max. deductible annual contribution
   a) Also, forfeitures can be reallocated without reducing maximum deductible
5. If employer has integrated both its pension and PSPs covering any of the same employees, the integration under both plans cannot exceed 100% of the integration capability of a single plan
   a) Objective is to avoid discrimination in favor of HCEs that would otherwise result

VI. PROVISION FOR DISTRIBUTIONS

1. Main objective of many deferred PSPs is to allow employees to save for financial security after retirement
2. Full vesting is mandatory at normal retirement age regardless of service
3. Most plans also fully vest at death, while many will vest at total and permanent disability
4. Vesting provisions will determine payout upon voluntary termination of employment
5. Employees are always entitled to the benefit attributable to his/her own contributions
6. Employer-provided cont'ns under a deferred PSP must vest upon severance, as per IRC
7. Plan must satisfy one of the alternative minimum vesting schedules

A. Withdrawals during Active Employment

1. Some plans permit withdrawals (partial or full) of vested benefits prior to separation
2. IRS interprets law to mean that accumulations cannot be paid out in less than 2 years
    a) Means 2 years after the year the contribution was made
3. Tax law also allows withdrawal upon the occurrence of an event such as hardship or completion of 5 years of plan participation

B. Loans

1. Some deferred PSPs also have loan provisions
2. How operate: Participant is allowed to borrow up to a specified percentage of the vested portion of his/her account
3. Advantage is that upon repayment the main objective would not be compromised
4. If structured properly, then sums borrowed are not subject to federal income tax
5. Interest payments not deductible though
6. Loans must:
    a) be available on a reasonably uniform basis to all participants
    b) bear a reasonable rate of interest
    c) be adequately secured
    d) be made only by the plan
7. If demands are met, then loan will be exempted from the prohibited transactions of ERISA and the IRC
8. Loan to employee treated as taxable distribution unless certain requirements are met, based on vested interest in account balance
9. The upper limit on loans from qualified plans is reduced by the excess of:
    a) The highest outstanding loan balance during the preceding 1-year period over
    b) The outstanding balance on the date a new loan is made
10. Loan must be evidenced by a legally enforceable agreement setting out the amount, term, and repayment schedule
11. Has Maximum repayment period for loan
12. Payments should be substantially level and be made at least quarterly
13. Exception: If loan is used to buy a residence (which becomes the participant's principal residence), then the max. time limit does not apply

VII. INVESTMENT OPTIONS

1. The PSP assets can be invested in a single fund with participants sharing proportionately in the fund's gains and losses
2. Most plans allow employees to direct their own investments by choosing among several different investment options
3. Options usually include two or more of the following:
   a) A guaranteed interest contract
   b) A corporate bond or fixed income fund
   c) A government bond fund
   d) One or more equity funds (varying degrees of risk), and
   e) An employer stock fund
4. A major reason for giving employees choice is to limit employer's fiduciary responsibility
   a) Some statutory relief is possible by complying with DOL regulations
5. DOL regulations require that:
   a) Plan offers at least 3 diversified categories of investment with materially different risk characteristics
   b) Participants have right to change investment choices at least quarterly
6. Same protection available to employer stock if shares are publicly traded and the three required options are offered
   a) All purchases, sales, voting and share activities must be implemented confidentially through a fiduciary
7. If employer stock is an investment, the SEC requirements will have to be met
8. Plan can also allow investment in life and health insurance
   a) If funds have accumulated for less than 2 years, more IRS requirements to be met
   b) Amounts used to buy these insurances must be incidental

VIII. OTHER REQUIREMENTS

1. Qualified PSPs must meet IRC requirements
2. E.g. must be in writing, be permanent, be communicated to employees, and prohibit diversion or recapture by employer of contributions to the plan
3. Follow ERISA requirements re service recognition
4. Must comply with top-heavy requirements of the law
5. Requirement to provide definitely determinable benefits does not apply to PSPs
6. Also, some other provisions of ERISA do not apply, e.g. Minimum funding standards and plan termination insurance requirements

IX. GENERAL CHARACTERISTICS

1. Money purchase pension plans are DC plans whose primary purpose is to provide financial support during retirement – they are technically pension plans
2. In some areas, they are treated the same as DB pension plans, for example
   a) Subject to minimum funding
   b) Subject to joint and survivor requirements
3. In other areas, the tax law treats them as DC arrangements
4. They have the same basic characteristics found in all DC plans
5. Employer contributions are usually expressed as a percentage of pay so that all employees, regardless of age, receive the same percentage-of-pay contribution
6. In a DB final-pay plan, the employer allocation takes into account both age and service

A. Allocation of Employer Contributions

1. Younger employees get much higher employer allocations under a DC plan than under a DB plan
2. Some feel this is equitable
3. Others feel that older, longer service employees should receive proportionately more
4. End result - DC plans generally have higher severance costs and potentially higher plan costs
5. possible to design the money purchase plan so that the pattern of allocations are similar to a DB plan

B. Inflation Protection

1. In a DC plan, the retirement benefits are effectively based on the employee's career average compensation
2. Some reflection of inflation during pre-retirement, because contributions are pay-based
3. No inflation protection during the postretirement period
4. In contrast a typical final-pay DB plan reflects inflation up to the retirement date and many provide "ad hoc" increases for their retirees after the pension commences

C. Investment Risk

1. In DC arrangement, employees assumes the risk and rewards of investment results
2. In DB plan, the employer assumes the risk and rewards

D. Other Characteristics of Money Purchase Plans

1. Contributions are usually a percentage of pay
   a) May also be a flat dollar amount
   b) Constitutes a commitment by employer, regardless of profits
2. Plan may require employees to make contributions in order to participate
   a) Such contributions can only come from after-tax income
   b) Contribution rate is fixed (cannot choose varying levels of participation)
   c) Employer's contribution is often set with reference to the employee's contribution (e.g. 100% match or 200% match, perhaps to a maximum)
3. Employees may be allowed to make voluntary contributions (does not result in any employer matching contribution)
4. Forfeitures arise when partially vested or non-vested employees terminate employment
   a) Can be used to reduce employer contributions or reallocated to remaining participants
5. Employer and employee contributions are transferred to a trustee (or insurance company under a group annuity type contract) and invested on behalf of the employees
6. Individual accounts are established for participating employees
   a) Credited with employee and employer contributions, reallocated forfeitures and investment gains and losses
7. Employees are often given a choice of several investment funds to invest their account balance in
8. The benefit at any time is what can be provided by the vested account balance
   a) At retirement, usually given choice of a lump sum or a monthly annuity – usually over period of life expectancy or joint life expectancy
9. Employee's account (even if not vested) is usually payable in full in event of death
10. Unlike profit sharing and savings plans, a money purchase plan cannot make distributions until employee has terminated employment
    a) In-service withdrawals are not permitted
11. Generally, money purchase plans focus on being retirement vehicles
    a) Although technically could provide for loans to employees
    b) Unusual in practice

X. CONTRIBUTION STRUCTURE

1. The cost of a given amount of benefit will depend on entry age, retirement age, contribution levels and investment results
2. Life annuities under an employer-sponsored DC plan must not differentiate based on gender
3. DC plans are often contributory
   a) Employer's contribution is often a match or a multiple of the employee's contribution
4. Inherent limitations of DC plans in providing retirement income
   a) Older new hire has too short a period to accumulate funds to provide adequate income More weight is given to lower compensation early in career than to the higher compensation later on, due to the effect of compound interest
   b) Benefit amount can only be estimated and is much more variable than under a DB plan – need to manage employee communications
   c) Money purchase plan is a career-average plan – but very uncommon to update the accrued benefits to take inflation into account

XI. TAX LAW PROVISIONS

1. Money purchase plans subject to almost all the tax law provisions applicable to qualified plans

XII. NONDISCRIMINATION IN CONTRIBUTIONS AND BENEFITS

1. If MPP involves after-tax employee and matching employer contributions, must pass an **actual contribution percentage ("ACP") test** every year under Section 401(m) of IRC
2. Test also applies to voluntary after-tax employee contributions even if there's no employer match
3. Test limits the participation of <u>Highly Compensated Employees ("HCEs")</u> so that their average contribution percentages cannot exceed the average contribution percentages of the non-highly compensated employees ("<u>NHCEs</u>") by more than a specified amount
4. If satisfy this test, then will also satisfy the nondiscrimination in contributions and benefits requirements of Section 401(a) (4) of the IRC
5. If ACP test is not applicable to employer contributions because employee contributions are not mandatory, then must satisfy non-discrimination part Section 401(a) (4) of IRC
6. Two possible **safe harbors**
   a) If plan has a uniform contribution formula – same percentage or dollar amount for every employee
      i) Must also have same vesting and definition of years of service for all
   b) Second safe harbor is for **nonintegrated "uniform points plans"** (other than ESOPs) that allocate contributions based on a formula weighted for age and/or service and units of pay less than $200
      i) Safe harbor is available if average of the allocation rates for HCEs does not exceed the average of the allocation rates for the NHCEs

XIII. SECTION 415 LIMITS

1. MPP is a DC plan under Section 415 limits
2. The annual addition to an employee's account has a maximum limit

XIV. JOINT AND SURVIVOR REQUIREMENTS

1. The pre and post retirement joint and survivor requirements apply to MPPs
2. Other DC plans are exempted from these requirements if:
   a) Employee's spouse is the beneficiary of 100% of the employee's account balance, unless the spouse consents in writing to the designation of another beneficiary

   b) The employee does not elect an annuity distribution, and
   c) The plan cannot have received a transfer from a pension plan
3. The exemption above is also available to MPPs that are part of an ESOP

XV. BEFORE-TAX CONSIDERATIONS

1. The CODA feature of Section 401(k) is not available to MPPs
2. These elective deferral contributions can only be made in conjunction with profit sharing, stock bonus, and savings plans that are qualified as profit sharing plans

XVI. FORFEITURES

1. Forfeitures due to non-vested terminations can be applied in 2 ways in MPPs
   a) Can reduce employer contributions, or
   b) Reallocated among remaining employees

XVII. EMPLOYER SECURITIES

1. In general, DB plans cannot invest more than 10% of assets in employer securities
2. Profit sharing and stock bonus plans can invest up to 100% of their assets in qualifying employer securities
3. However, money purchase plans, even though they are DC plans, are subject to the same 10% limit that applies to DB plans

XVIII. IN-SERVICE DISTRIBUTIONS

1. MPP is not permitted to make in-service distributions
2. Can only distribute in event of termination of employment in some fashion
3. Also allow so in plan termination

XIX. MINIMUM FINDING STANDARDS

1. Since it is a pension plan, it is subject to same funding requirements
2. No actuarial valuation is required
3. Must still maintain a <u>minimum funding standard account</u>
   a) Much simpler in operation than for a DB plan though
4. The required funding contribution must be made in full each year
5. There is no funding flexibility at all

XX. DEDUCTION LIMITS

1. Prior to EGTRRA, no specific deduction limits for MPPs
2. under EGTRRA, uniform limit of 25% of compensation for all DC plans

Retirement Plans 12th Edition (By Allen et al)

Chapter 7 Employee Stock Ownership Plan

I. DEFINITION

1. IRC definition of ESOP
   a) Qualified stock bonus plan or combination qualified stock bonus plan and money purchase plan mainly invests in ER securities
      i) Stock bonus plan allow cash contributions but EE must have the right to demand distribution in ER securities
   b) Exist primarily for EE benefits
2. Simple (Non-leveraged ESOP)
   a) Each year, ER gives to ESOP stock or cash to buy stock
   b) No EE contributions
   c) EE collect stock or cash upon plan exit (according to vesting schedule)
3. Leveraged ESOP
   a) Banks lend money to ESOP with ER guarantee
   b) ESOP buys stock from ER or existing shareholders
   c) Stocks held in unallocated suspense account
   d) Annual tax deductible ER contributions to ESOP, which in turn repays bank
   e) As bank loan is repaid, shares is released from unallocated suspense account to EE individual accounts
   f) EE collect stock or cash upon plan exit (according to vesting schedule)

II. EMPLOYER ADVANTAGES OF LEVERAGED ESOP

1. Effective device to change a public entity into a private one
2. Disposal of corporate division
   a) Selling company established a new company
   b) New company established ESOP to raise capital and purchase the division
3. Provide estate liquidity to major shareholder
4. Takeover protection (Relatively large blocks of ER share in "friendly hands")
5. Lower expenses and complexities of selling stock to public or existing shareholders
6. Create proprietary interest among EE
7. Supplement existing compensation and benefit plans

III. EMPLOYER DISADVANTAGES OF LEVERAGED ESOP

1. Must fully evaluate financial implications
   a) Not a tax efficient way to raise capital (vs. conventional debt and equity financing)
      i) Charge to corporate earnings
      ii) Dilution in share value and cash flow implications
      iii) Continuation of ER contributions after debt retirement
2. No ER stock in allocated suspense account can revert to ER if trust is terminated prematurely
3. Disqualification for failing "exclusive benefit" requirement
4. Inefficient compensation tool if stock appreciation comes from
   a) ER forgoing tax deduction for capital appreciation on shares that under a non-leveraged plan would have been made in future years

IV. EMPLOYEE ADVANTAGES OF LEVERAGED ESOP

1. Share appreciation not part of EE annual addition under Section 415
   a) Advantage to highly compensated EE
2. Greater assurance of ER contribution than profit sharing plan

V. EMPLOYEE DISADVANTAGES OF LEVERAGED ESOP

1. EE financial security too closely related to ER

Retirement Plans (12th edition by Allen et al)

Chapter 8: Cash or Deferred Plans under Section 401(k)

I. INTRODUCTION

1. Intense scrutiny recently due to Enron case
2. 401(k) plans is a major component of most employees' retirement security
3. Pension Protection Act of 2006 furthers protects plan members
   a) Permit investment companies administering the plans to provide more comprehensive investment advice to EEs
   b) Allow EE to diversify out of ER stock
   c) Clarify automatic enrollment for EE who failed to enroll upon hire
   d) Guidance on default investments
   e) More accelerated vesting schedules

II. ADVANTAGES AND DISADVANTAGES OF CODAS

1. There are significant advantages of CODAs, especially to employees
2. CODAs have all the advantages for the employer as any employee benefit plan, e.g.
   a) Attracting and retaining
   b) Improving employee morale
   c) Sense of corporate identification
3. Aids specific corporate objectives, e.g.
   a) Increasing participation in existing plan that has after-tax contributions
   b) Converting a conventional savings plan to a CODA could minimize pressure to increase pay (since employees have increased take home pay)
4. From employees' perspective, main advantage is taxes
5. Converting a conventional savings plan to a CODA will result in an immediate increase in take-home pay
6. Even more important, the contributions are accumulating in a tax-sheltered vehicle
   a) Over time, this advantage can be very significant
7. When amounts are distributed and taxable, participant may be in a much lower tax bracket
   a) Lower taxable income
   b) Indexed tax brackets
8. Employees have annual choice to take amounts in cash or to defer these further
9. There are disadvantages for employers:
   a) Complex and costly to administer
   b) May have employee relations issues in any year if fail to satisfy ADP and ACP tests
   c) Greater communication effort required
10. Only significant disadvantage for employees:
    a) Elective contributions are subject to withdrawal limitations and possible application of early distribution tax

III. THE FUTURE

1. Most companies already established CODAs or converted existing plans to one
2. Strong continuing trend
3. Likely there will be legislative changes impacting CODAs but essential characteristics of 401(k) plans will like remain unchanged

4. CODAs are a tax-efficient way of providing employee benefits
5. Flexible to accommodate changing needs of employees over time
6. A 401(k) provision can be added to a conventional deferred profit sharing plan, a savings plan, a stock bonus plan, or an employee stock ownership plan
   a) So a 401(k) is not a specific type of plan, but rather a set of provisions
   b) Gives employees a choice of receiving an employer contribution
      i) In cash, or
      ii) Deferring it under the plan
   c) Gives employees the choice of making his/her own before-tax contributions
   d) Federal tax on these amounts do not apply until time of distribution

IV. <u>LEGISLATIVE HISTORY OF CODAS</u>

1. Pension Protection Act (2006)
   a) Post-2006 ER contributions must vest similar to either a 3-year cliff or 6-year graded vesting schedules (only affect plans where ee contribution is not a requirement for ER matching cont)
   b) Allow EE to diversify out of publicly traded ER stock
      i) Generally allow EE to immediately diversify investments resulting from elective deferrals and after tax contributions
      ii) Must be permitted for EE with at least 3 years of service
      iii) Must offer at least 3 other diversified investment options
      iv) Provide notice at least 30 days before the date EE become eligible to diversify
2. Amended ERISA preempting any state wage and hour law that directly or indirectly prohibits or restricts automatic enrollment features in DC plans
3. Provide EE notice of their rights and obligations under the automatic enrollment plan
4. Notice to describe default option for automatic contributions
5. Added new optional nondiscrimination safe harbor plan design using an automatic enrollment feature effective after 2007
6. Changes notice and consent rule applicable when a plan distribution occurs. Extend from 90 to 180 days
7. Mandated notice to describe the consequences of a failure to defer receipt of distribution
8. Expanded conditions which allowed for hardship distribution
9. EGTRRA provisions affecting retirement plans now permanent

V. <u>TECHNICAL REQUIREMENTS</u>

1. IRC **Section 401(k)** states that a qualified CODA is any arrangement that:
   a) Is part of a:
      i) Profit sharing plan or stock bonus plan
      ii) Pre-ERISA money purchase plan, or
      iii) Rural electric cooperative plan that meets Section 401(a) requirements
   b) Permits employees to elect to have employer make contributions either:
      i) To a trust under the plan, or
      ii) Directly to the employees in cash
   c) Subjects to amounts held in trust on behalf of an employee to certain specified <u>withdrawal limitations,</u> when those amounts are employer contributions made pursuant to an employee's election
   d) Provides that benefits derived from such contributions are <u>non-forfeitable</u>
   e) Does not have a service eligibility requirement of more than 1 year in order to participate in plan
2. CODA must meet all nondiscriminatory requirements applicable to tax-qualified plans

3. Some special requirements for CODAs are discussed later on in this chapter
4. Different types of employee / employer contributions that can be made under a CODA:
   a) Elective contributions (a.k.a. pretax contributions or elective deferrals) are amounts an employee chooses to have the employer contribute to a CODA on a pretax basis, either by way of
      i) A salary reduction (e.g. typical savings plan), or
      ii) Election to defer (e.g. cash option profit sharing plan)
   b) After-tax employee contributions are monies an employee is deemed to have received and taken as income
   c) Matching contributions are employer contributions made when an employee authorizes an elective deferral or makes an after-tax employee contribution
   d) Non-elective contributions are employer contributions made on behalf of employees regardless of whether they have made elective deferrals
   e) Qualified non-elective contributions (QNECs) are non-elective contributions to which 2 special rules apply
      i) Contributions are fully vested at all times, and
      ii) Generally no in-service distributions for any reason before age 59.5
   f) Qualified matching contributions (QMACs) are matching contributions that meet the same rules for QNECs
   g) Safe harbor contributions are employer contributions made to allow a plan to meet safe harbor requirements and avoid the need for ADP testing
      i) Has same rules as for QNECs
   h) Employee catch-up contributions are increased elective deferrals for employees who are ≥ age 50 before the end of the tax year
      i) Basically allows a higher level of elective deferrals
      ii) Not subject to any other limits
      iii) Not taken into account when applying other limits
      iv) Employer will not fail nondiscrimination rules if all participants allowed to make same election regarding catch-up contributions
   i) Designated Roth contributions are employees contributions
      i) Employee elects to have all or a portion of annual elective deferral treated as an after-tax "Roth contribution"
      ii) Employer must have a "qualified Roth contribution program" as part of the 401(k) plan
      iii) A 403(b) plan may also offer such a program
      iv) Advantage of this election for employees is that although contributions are taxed currently when contributed, qualified distributions from a designated Roth account (including investment earnings) are not subject to taxation when paid
      v) Since treated as elective deferrals, they are fully and immediately vested
      vi) Has general withdrawal restrictions
      vii) American Taxpayer Relief Act expand the ability to transfer from 401(k), 403(b) and 457(b) plans into post-tax savings within designated Roth accounts

VI. TYPE OF PLAN

1. Only qualified DC plan that **cannot** be established as a CODA is a post-ERISA money purchase or DC pension plan
2. CODAs fall into 2 categories
   a) Cash
   b) Deferred profit sharing plans or savings plans

3. CODAs can also fall into 3 types based on contributions
   a) Employer contributions only
   b) Employer and employee contributions
   c) Employee contributions only

VII. INDIVIDUAL LIMITATIONS

1. There is a limitation on exclusion for elective deferrals for any taxable year
2. Any excess amounts are included in employee's gross income
3. Limit applies to the aggregate elective deferral made to all CODAs in a tax year
4. Another limit caps the amount of pay recognized for most qualified plans including determining level of contributions and benefits

VIII. NONDISCRIMINATION IN COVERAGE AND CONTRIBUTIONS

1. CODA will not be tax-qualified unless meet coverage provisions (Chapter 4) and contributions under the plan are nondiscriminatory
2. For contributions to be nondiscriminatory:
   a) Meet actual deferral percentage (ADP) test if there are after-tax contributions
   b) Meet actual contribution percentage (ACP) test
   c) No testing (except for ACP test for after-tax employee contributions) needed if safe harbor contributions are made (described later in chapter)
3. The ADP test is done at the close of each plan year and is purely mathematical
   a) Calculate the ADP for each eligible employee, whether or not they are participating
   b) $\text{ADP}=\dfrac{\text{cont'ns deferred by employee election + QNECs/QMACs per employer election}}{\text{employee's compensation}}$
   c) Divide eligible employees into two groups – the highly compensated employees (HCEs) and all others being the non-highly compensated employees (NHCEs)
   d) If the average of the ADP for HCEs do not exceed the average for NHCEs by more than the allowable amount, then test is satisfied
   e) Alternative limit can result in higher ADP for HCEs in many cases
      i) ADP_{HCE} may be as high as 2 x ADP_{NHCE} but not more than 2% higher
   f) ADP test can be done excluding any NHCEs who participate before age 21 and completing 1 year of service
      i) If plan separately passes the 410(b) coverage tests for all participants in that age/service group
   g) It is possible that individuals that are HCEs can have an ADP higher than the maximum because the maximum is based on the average for the HCE group
4. If any HCE is a participant under 2 or more CODAs, then all CODAs treated as one
5. ACP test applies to any after-tax employee contributions & employer matching cont'ns
6. Some techniques for employers to minimize likelihood of failing the ADP or ACP tests:
   a) Make safe harbor contributions
   b) Use prior year ADPs of NHCEs
   c) Design plan to have automatic compliance
   d) Encourage maximum participation from the NHCEs (e.g. by providing higher employer contributions for lower pay levels or with lower rates of contribution)
   e) Limit amounts that can be deferred or contributed
   f) Make a mandatory minimum deferral or cont'n from all participating employees

g) Have provision allowing employer to adjust future deferrals or after-tax contributions if plan is in danger of failing the tests
h) Make additional employer QNEC or QMAC contributions at the end of plan year
i) Determine contributions for a plan year in advance so that it would pass

IX. SAFE HARBORS – ADP/ACP TESTING

1. CODA will satisfy nondiscrimination tests for elective contributions by using one of two safe harbors:
   a) Providing certain matching contributions to NHCEs, or
   b) Making a contribution of 3% of compensation for all NHCEs, regardless of whether they contributed to the plan
2. Also, ACP testing not required for matching contributions if:
   a) Plan provided for a safe harbor matching contribution, and
   b) No match was provided on contributions in excess of a certain % of compensation
   c) ACP test is still required for after-tax employee contributions
3. Safe harbor matching contributions must be within a prescribed range
   a) Other formulas for matching contributions will qualify for safe harbor treatment if provides a matching contribution ≥ the safe harbor formula, and
      i) Percent matched does not increase as the employee's contribution increases
   b) Rate of match for HCEs ≤ rate of match for NHCEs
4. To meet safe harbor:
   a) Eligible employees must be informed of their opportunity to participate in the CODA prior to the beginning of the year, and
   b) The matching contributions must be fully vested and subject to same restrictions on distributions as QNECs and QMACs (i.e. only distributed in case of separation from service, death, disability, or attainment of prescribed age

X. TREATMENT OF EXCESS DEFERRALS AND CONTRIBUTIONS

1. Excess deferrals arise if amount deferred by an employee exceeds the elective deferral limit for the year
2. Excess contributions arise as a result of failure of the ADP or ACP tests
3. Excess deferrals may be allocated to plans under which the deferrals were made by March 1 following close of tax year
   a) Plan may distribute allocated amount back to the employee
   b) Included in employee's taxable income, but not subject to excise tax
4. Income earned on excess deferrals are deemed as earned and received in the tax year
5. Any excess deferrals not distributed by April 15 will remain in the plan and be subject to all regular withdrawal restrictions
   a) Amount will again be included in taxable income when it is later distributed
6. If excess contributions arise, possible solutions to problem are:
   a) Make additional employer contributions to pass the test
   b) If fail ADP test, re characterize the excess deferrals as after-tax employee contributions
      i) They will then be subject to ACP test
   c) Refund excess contributions using methodology prescribed in regulations
7. The correct legal terminology is:
   a) An excess attributable to failure of ADP test is called an excess contribution
   b) An excess attributable to failure of ACP test is called an excess aggregate contribution

8. Two critical dates if wish to return excess contributions or excess aggregate contributions
   a) 2.5 months after end of plan year in which excess occurs
      i) If excess returned by this time, generally consider amount as income
      ii) Return of after-tax contributions will not be taxable
      iii) Investment income on both after-tax and elective deferrals, will be taxable in year that amount deferred would otherwise have been received in cash
      iv) Amounts distributed will not attract 10% excise tax on early distributions
   b) Last day of plan year following the plan year in which excess occurred
      i) If distribute between first critical date and the second critical date, included in income in year of distribution
      ii) Employer is also subject to a penalty tax on the principal (but not earnings)
9. If excess contributions are not returned by second critical date – can have serious consequences
   a) If an excess contribution, CODA portion could lose qualified status for the years in question
      i) All employees could be taxed on amounts they could have received in cash
   b) If an excess aggregate contribution, entire plan could lose qualified status for years in question
      i) Loss of deductions, tax on investment income, tax of all employees to extent of their vested balances
10. Corrective distributions for failure to satisfy the ADP or ACP tests are taxable in year of distribution
    a) Need not include the differential period income if distributed within the period prescribed to avoid the excise tax

XI. NONFORFEITABILITY REQUIREMENTS

1. Value of all elective and after-tax employee contributions to a CODA must be fully vested
2. QNECs, QMACs and safe harbor contributions must also be fully vested
3. Other employer contributions must vested as per one of ERISA's standards
4. Vested amount of elective contributions not considered for this purpose

XII. LIMITATIONS ON WITHDRAWALS

1. Common in profit sharing and savings plans to permit withdrawals of part of the vested account balance while actively employed
2. Sometimes, limit this to "hardship" situations
3. More often, withdrawal will be allowed for any reason, but will typically be subject to a period of suspension from plan participation
4. For CODAs, in-service withdrawals are much more restricted:
   a) Elective contributions can only be payable upon death, disability, separation from service, plan termination, or certain sales of businesses by employer
5. Elective contributions can be distributed after employee has attained age 59 ½, or before this age if based on hardship
   a) Hardship cases limit to only the elective contributions themselves (no investment income)
6. Safe harbor contributions have similar withdrawal restrictions
7. Limiting withdrawal of elective contributions to hardship cases may have negative effect on the participation, especially of lower paid employees
   a) May result in difficulty passing the ADP and ACP tests
8. Normally following events are acceptable hardship cases:
   a) Medical expenses incurred by employee, spouse, dependents
   b) Buying a principal residence
   c) Educational costs and fees for next 12 months (incl. room and board, etc.)
   d) Needed to prevent eviction from principal residence or on the foreclosure on the mortgage

9. Hardship can be determined on a "facts and circumstances" basis
10. Regulatory safe harbors to allow withdrawal have 4 conditions:
    a) Distribution must not exceed amount of the need
    b) Employee must have "used up" all distributions (except hardship) available and also all nontaxable loans currently available under all plans sponsored by employer
    c) Plans must provide that employee's elective and after-tax contributions will be suspended for ≥ 6 months after receipt of distribution
    d) Plan and all ER plans must limit employee's elective contributions for the immediately following calendar year to:
        i) The excess, if any, of that year's elective contribution limit over the amount electively contributed in the year of the distribution
11. Plan may use a "facts and circumstances" approach, rely on safe harbors, or both in designing and administering hardship withdrawal provisions
12. Some amounts are available for non-hardship in-service withdrawals:
    a) Employer contributions (unless part of ADP test)
    b) After-tax employee contributions
    c) Employer or employee contributions made to a plan before it became a CODA
    d) Even elective contributions may be withdrawn (non hardship) after age 59 ½
13. PPA directed IRS to modify existing hardship rules
    a) Permit each of the allowed conditions to be met on a "facts and circumstances" basis
        i) Certain medical expense by EE, spouse, beneficiary and certain dependents
        ii) Principal residence purchase
        iii) Education related fees for next 12 months of post-secondary education
        iv) Prevention of eviction form principal residence
    b) Also provide regulatory safe harbor withdrawals if
        i) Distribution must not exceed the amount of need
        ii) EE must used up all non-hardship distributions and non-taxable loans available
        iii) ER must suspend EE's electives and after tax contributions for at least 6 months after distribution
        iv) Limit EE's elective contributions for the following calendar year to (current year elective contribution limit – amount electively contributed in distribution year)
        v) In military duty > 179 days between September 11, 2001 to year end 2007

XIII. SEPARATE ACCOUNTING

1. Amounts held by a plan with a CODA is subject to CODA non-forfeitability and withdrawal requirements unless a separate account is maintained for benefits specifically subject to these requirements
2. Included are:
    a) Amounts contributed before 1980
    b) Contributions not subject to a deferral election
    c) Contributions made for years when the CODA is not qualified
3. Separate accounting for plan years after 2005 if employers offer a "qualified Roth contribution program" in connection with a 401(k) plan
    a) A 401(k) or 403(b) plan with option of a qualified Roth contribution program must establish, for each employee, a separate "designated Roth account" that will hold Roth contributions and earnings

XIV. LOANS

1. Many employers have loan provisions in their CODA programs (due in part on the in-service withdrawal restrictions)
2. Same legal requirements for in CODAs as for loans in profit sharing plans

XV. SOCIAL SECURITY

1. Elective contributions are wages for Social Security and federal unemployment insurance purposes

XVI. OTHER EMPLOYER-SPONSORED PLANS

1. IRS has ruled that the inclusion (or exclusion) of elective contributions under a CODA as compensation in a defined benefit pension plan does not cause the pension plan to be discriminatory
2. No legal reasons why pay, for purposes of other pay-related employee benefit plans, cannot be defined to include elective contributions made under a CODA:
   a) Short and long-term disability income plans
   b) Group term life insurance
   c) Survivor income benefits
   d) Health care plans
3. CODA will not be qualified if any other benefit provided by employer is conditional (directly or not) on the employee's electing to have employer make or not make contributions under the arrangement in lieu of receiving cash

XVII. STATE AND LOCAL TAXES

1. Most state and local authorities have said they will follow federal tax law with respect to treatment of elective contributions
2. A few have said that elective contributions will be taxable and subject to employer withholding
3. Reasonable to expect that other state and local authorities might also take this latter position

XVIII. DEDUCTION LIMITS

1. Section 404 of IRC limits employer deductions for contributions to qualified plans
   a) Profit sharing plans has prescribed limit
2. If employer has both a defined benefit plan and a defined contribution plan, has combined limit
3. Elective deferrals to qualified CODAs are included in the definition of compensation
4. Elective deferrals to qualified CODAs are no longer deemed employer contributions and they are not subject to employer deduction limitations

Retirement Plans (12th edition by Allen et al)

Chapter 9 Section 403(b) Plans

I. INTRODUCTION

1. A 403(b) plan is a retirement vehicle for employees of public educational institutions and certain nonprofit tax-exempt organizations
2. Allows thousands of organizations to provide their employees an opportunity to save for retirement on a tax-deferred basis
3. Can be structured in different ways, e.g.
   a) Fully contributory and elective basis with no employer contributions
   b) With employer contributions and with or without employee contributions
   c) Employer contributions can be:
      i) Fixed without mandatory employee contributions
      ii) Fixed on a matching basis requiring employee contributions
      iii) Variable and used to reward employees for meeting goals
   d) All three variations can allow voluntary, unmatched employee contributions
4. Typically, employees can elect to have their salaries reduced, pursuant to a salary reduction agreement, and apply that reduction to purchase 403(b) annuities
   a) Often called a tax-deferred annuity (TDA) plan or supplemental retirement annuity (SRA)
   b) Generally does not involve employer contributions
5. If employer contributes to a 403(b) plan by using matching contributions and/or discretionary contributions in addition to employees' tax-deferred salary reduction contributions, sometimes this makes up the employer's basic retirement plan

II. BASIC REQUIREMENTS

1. The essential requirements to obtain the tax advantages similar to qualified plans are:
   a) Employer must be a qualified educational or nonprofit organization or a public school system (or public college or university)
   b) Participant must be a bona fide employee
   c) Participants rights must be non-forfeitable
   d) Contributions paid in any year must be less than:
      i) Exclusion allowance for the years prior to 2002
      ii) IRC Section 415 limits
      iii) Annual limit on salary reduction contributions, or
      iv) Maximum amount permitted under the nondiscrimination requirements
   e) Meet nondiscrimination requirements for plans involving employer contributions
      i) If only voluntary employee contributions are involved, then require to have same salary reduction opportunity open to all employees
   f) Annuity contract must be purchased by employer, or employer must deposit to a custodial account that will purchase mutual fund shares

III. QUALIFIED EMPLOYERS

1. Nonprofit organization qualified under IRC Section 501(c) (3), e.g.
   a) Tax-exempt hospital, church, school, charitable organization, etc
2. Public school system or public college/university ("system" will include such colleges/universities)

IV. <u>ELIGIBLE EMPLOYEES</u>

1. Must be a bona fide employee
2. Doesn't matter if high or low paid, full-time or not
3. Cannot be an independent contractor – e.g. professional people

V. <u>NONFORFEITABLE EMPLOYEE RIGHTS</u>

1. Benefits under the plan belong to employee
2. Normally, ownership would be vested solely in the employee
   a) Therefore, no worries about insolvency or change in control of company

VI. <u>CONTRIBUTIONS</u>

1. Two types: non-elective and elective contributions
2. **<u>Non-elective contributions</u>**: those that employer makes to basic retirement plan on participant's behalf
3. **<u>Elective contributions</u>**: voluntary employee contributions to a tax-deferred annuity under a salary reduction agreement
   a) Can include contributions that employee must make in order to receive matching employer contributions under the basic plan
4. Participants in 403(b) plans can enter salary reduction agreements as frequently as plan allows as long as the:
   a) Has not been paid, or
   b) Is not available to be received at the employee's discretion
5. Both elective and non-elective contributions must be made by the employer
   a) Excluded from employee's gross income for current year if not exceed limits
6. Three limits for 403(b) plans are (described below in more detail):
   a) Elective deferral limit on contributions made pursuant to salary reduction arrangements
   b) An annual exclusion allowance limitation for years prior to 2002
   c) An annual limit on total contributions (Section 415 annual limit)

VII. <u>LIMITATION ON SALARY REDUCTION CONTRIBUTIONS</u>

1. Has maximum amount an individual can contribute to all 403(b) plans
   a) This limit moves in tandem with limit for 401(k) CODA elective deferrals
2. Elective deferral limit does not apply to employer contributions to a 403(b) plan
3. The 402(g) limit is reduced to extent employee made elective deferrals in:
   a) A 401(k) plan
   b) A SIMPLE plan
   c) A simplified employee plan (SEP)
4. In special cases, can contribute more than 402(g) limit
   a) Called a **special "catch-up" election**
   b) Available to an employee of a qualifying organization who has entered into a salary reduction agreement with employer and has ≥ 15 years service
5. Has limit on additional contributions above the 402(g) limit
6. Employee catch-up contributions are not subject to any other contribution limits and also are not considered in applying other contribution limits to other contributions or benefits under a plan
   a) Will not fail Section 401(a) (4) rules if allow all eligible participants to make the same election regarding catch-up contributions

VIII. IRS SECTION 415 LIMIT

1. EGTRRA increased Section 415 limits for DC plans
2. Limits include both employer and employee contributions and any allocation of forfeitures due to non vested terminations

IX. IRS SECTION 401(A) (17) LIMIT ON INCLUDIBLE COMPENSATION

1. This is the maximum amount to be used in calculating retirement plan contributions or benefits
2. Also used in nondiscrimination testing

X. LIMITS ON ELECTIVE DEFERRALS UNDER SECTION 402(g)

1. Elective deferral limit does generally apply to the total of the employee's other elective deferrals for the taxable year, including:
   a) CODAs
   b) SIMPLE plans, and
   c) Salary reduction simplified employee pensions (SARSEPs)
2. Employee can also elect to treat part of annual elective deferral as an after-tax "Roth contribution"
   a) See Chapter 11 for more details of Roth contribution programs
3. Monies contributed to a qualified Roth program are taxed currently, but qualified distributions (including investment earnings) are not taxed
4. Limits on elective deferrals apply to each individual 403(b) contract rather than the 403(b) plan as a whole
5. American Taxpayer Relief Act expands the ability to transfer from 401(k), 403(b) and 457(b) plan into posttax savings within Designated Roth A/c

XI. NONDISCRIMINATION REQUIREMENTS

1. Except for church plans, 403(b) annuity arrangements are subject to extensive IRC nondiscrimination rules

A. First Non Discrimination Rule

1. Generally applies same rules governing coverage that apply to qualified retirement plans to non salary reduction contributions made to 403(b) plans
2. Contributions are subject to the IRC Section 401(a) (17) limit on compensation that can be taken into account

B. Second Nondiscrimination Rule

1. Employer and non salary reduction employee contributions must meet the actual contribution percentage (ACP) tests
2. These compare the ACP for highly compensated employees and non-highly compensated employees
3. Test is basically the same as that applied to 401(k) plans
4. See Chapter 11

C. Third Nondiscrimination Rule

1. Applies only to salary reduction contributions
2. If employer permits employees to make such contributions, then must make available to all employees, except for prescribed exclusion
3. 403(b) plans are not allowed to impose minimum age and service requirements

XII. ANNUITY CONTRACT PURCHASED BY AN EMPLOYER

1. IRS has stated that insurance companies and mutual funds must be used
2. 403(b) allows a contract which provides incidental life insurance protection to be an annuity contract
   a) Presumably the "incidental life insurance protection" has same meaning as it has for insurance purchased under qualified plans
3. Also includes a so-called face-amount certificate but does not include a contract or certificate that is transferable
4. Most annuity contracts issued allow flexible premium payments
   a) Adaptable to varying incomes and variable frequency of payment
5. Payment of premiums satisfies the purchase requirement

XIII. REGULAR AND PREMATURE DISTRIBUTIONS

1. Distributions from 403(b) plans are basically subject to same restrictions as elective deferral contributions made to qualified 401(k) plans
2. Generally, distributions of salary reduction contributions and investment earnings thereon may be made from a 403(b) plan under the following circumstances:
   a) Attainment of prescribed age
   b) Death or disability
   c) Separation from service
   d) Financial hardship (only salary reduction contributions, not investment earnings)
3. Distributions from a 403(b) plan are included in ordinary income for federal tax purposes in the year received
   a) Unless rolled over into an individual retirement account (IRA) or another 403(b) plan
4. A premature distribution penalty tax applies to any distribution from a 403(b) plan before age 59.5
5. The premature penalty tax does not apply under the following conditions:
   a) Separation from service after age 55 and distribution is received upon separation
   b) Employee's death or disability
   c) Separation from service, if receive a distribution of substantially equal periodic payments over life expectancy
   d) If employee rolls the distribution over into an IRA or other tax-favored vehicle
   e) Used to pay medical expenses that are deductible for federal income tax purposes
   f) To someone other than the employee under a qualified domestic relations order

XIV. TIME WHEN DISTRIBUTIONS MUST COMMENCE

1. Must begin receiving distributions from a 403(b) annuity plan by the later of:
   a) April 1 following the year of attaining age 70.5, or
   b) Calendar year following year in which the employee retires
2. Amounts credited prior to 1.1.1987 need not be distributed until age 75
3. If distribute in periodic payments, a minimum distribution is required based on the life expectancy of the individual or the joint life expectancies including his beneficiary
4. If less than the minimum, then there is a 50% penalty tax on the difference between amount actually distributed and the minimum amount needed

XV. TAXATION OF DISTRIBUTIONS

1. Lump sum distribution from a 403(b) plan is taxed as ordinary income
2. No capital gains tax rates nor income averaging is available
3. Only part not subject to tax is any cost basis on which tax has previously been paid on his/her contributions or for any incidental life insurance costs
4. Installment payments under a 403(b) plan are taxed in accordance with the annuity rules applicable for qualified plans

XVI. LOANS

1. Loans under 403(b) plans generally are permitted on the same basis and with same limits as under qualified retirement plans
2. Must meet the following IRC requirements:

XVII. TRANSFERS

1. Transferability refers to ability to move some or all of a participant's 403(b) assets among different funds or providers sponsored by the employer
   a) Subject to plan provisions
2. May also be allowed to transfer to another 403(b) plan without federal income tax consequences
3. The term "transferability" used above should not be confused with the requirement that a contract must be nontransferable meaning it cannot be sold, assigned or pledged as security for collateral

XVIII. ROLLOVERS

1. Distributions from a 403(b) plan are not included in gross income if properly rolled over
2. Basically, if employee receives a distribution and then rolls it into an IRA or another eligible plan, then it is a valid rollover
3. If property other than money is distributed, must transfer that same property
4. Rollover must be completed within 60 days of receipt of the distribution
5. An eligible rollover distribution is any distribution from a 403(b) plan, but exclude:
   a) Distribution required because of minimum distribution rules
   b) Certain periodic distributions
   c) Any distribution made on account of hardship
6. Unless made in the form of a direct rollover (plan to plan, without going through participant's hands), subject to a federal income tax withholding

XIX. INCREASED PORTABILITY

1. Rollover distributions may occur between:
   a) Qualified plans
   b) 403(b) plans
   c) Eligible governmental 457(b) plans
2. Governmental 457(b) plans can also be rolled over into IRAs
3. After-tax contributions from a qualified DC plan [e.g. 401(a), 403(a) or 401(k)] can be directly rolled over to another qualified DC plan
   a) Such amounts may also be rolled over directly or indirectly to an IRA

4. Pension Protection Act (2006)
   a) Allow direct rollover from 403(b) plans to Roth IRAs after 2007
   b) Clarifies after 2006 after-tax amounts can be rolled over tax free from a qualified retirement plan to tax-sheltered annuity

XX. REGULATIONS PROVIDING 403(B) GUIDANCE

1. Proposed IRS regulations on:
   a) Written documentation requirements
   b) Return of excess EE deferrals
   c) New required ER communications
   d) Transfer rules
   e) Time limits on 403(b) deposits
   f) Allowance for ER contributions to former EE
   g) Coordination of catch up limits
   h) Roth contributions
   i) Restrictions on use of life insurance within plan
   j) Plan terminations

Retirement Plans 12th Edition (By Allen et al)

Chapter 10 Section 457 Deferred Compensation Plans

I. BACKGROUND

1. Usage
   a) Pure deferred compensation plans to reduce taxable salary
   b) Supplemental benefits plans for executives
2. Advantages: Can shield from
   a) Tax doctrines of economic benefit
      i) Economic benefit results when provided to EE as compensation
      ii) E.g. Cash compensation, assets put in trust for sole benefit of EEs
   b) Constructive receipt
      i) Income (not necessarily received in hand by an individual) is considered received and therefore currently taxable.
3. Events leading to 2a) or 2b) results in deferred amounts becoming available to EE, thus subject to current taxation.

II. INTRODUCTION OT SECTION 457 PLANS

1. Non qualified deferred compensation plans for state and local governments and NGO exempt from tax
2. Types of section 457 plans
   a) Eligible plans Section 457(b) plans
   b) Ineligible plans Section 457(f) plans

III. ELIGIBLE PLANS

1. Taxation
   a) In government ER
      i) Deferred income and earning tax free until distributed
   b) In NGO
      i) Deferred income and earning tax free until distributed or made available
2. Eligibility
   a) Only EEs and independent contractors can join
   b) EE must have authorized deferrals in advance
3. Maximum Annual Deferral
   a) Limit by EGTRRA
   b) (Deferred amounts – Limit > 0) subject to normal taxation in taxable year deferred
   c) For plan ceilings: deferred income must be at current value in the
      i) Plan year deferred or
      ii) Plan year when forfeiture risks lapses
4. Catch Up Provisions
   a) ≥ Age 50 EE can make an additional $1,000 above dollar limit
   b) Plan must specify NRA
      i) Min (65, earliest unreduced retirement age) or within the range
      ii) Max age 70.5

5. Coordination with other plans
   a) N/A: Can defer Section 457(b) plan ceiling regardless of contributions to other plan
   b) Pension Protection Act (2006) made permanent 5a)
6. Funding Requirements
   a) Tax-exempt NGO:
      i) Deferred amounts and earnings sole property of ER (and general creditors) until made available to participants
   b) Government ER
      i) Deferred amounts and earnings in trust for EE
7. Investment options available to participants
   a) Tax Exempt NGO
      i) Informal funding
      ii) EE can direct investments but no secured interest in the purchased assets
   b) Government ER
      i) EE can choose among investment options offered
   c) Predominant investment manager: Insurance companies
8. Loan provisions
   a) Tax-exempt NGO: N/A
   b) Allowed for government ER
      i) Under terms applicable to qualified retirement plans
      ii) May or may not be treated as a distribution
9. No early distribution unless
   a) Plan has loan features
   b) Qualified domestic relations order (EFTRRA made permanent)
   c) Severance at termination, death, disability or retirement
   d) Unforeseeable emergency (PPA mandated new hardship rules)
   e) Age 70.5
10. Plan Distributions
    a) Subject to regular income tax unless irrevocably elects further deferral
    b) For former EE, can exclude from gross income if
       i) Transfer to another 457(b) / qualified / annuity / individual retirement plans (vice versa is also true)
       ii) Direct transfer of eligible 457(b) plan distribution to a DB government plan if for purchase of service credit or a repayment to which Section 415 does not apply
    c) 10% early withdrawal penalty tax N/A Section 457 plan except for portions attributable to rollovers from another type of plan
11. PPA (2006)
    a) Clarified permissive service credit
    b) Directed IRS to issue regulations on meeting minimum required distribution rule
12. IRA approval not needed
    a) Can apply for private letter rulings indicating plan meets Section 457 requirements
    b) Government has grace period to amend the plan to meet the eligible plan requirements (not so for tax exempt NGO)
    c) If not amended, is an ineligible plan

IV. INELIGIBLE PLAN REQUIREMENTS

1. Deferrals Amount
   a) No limit on deferral amounts made
   b) Must subject to substantial risk of forfeiture
      i) I.e. Right to receive benefits conditioned on future performance of substantial services
   c) Must satisfy IRC 409A
   d) Better suited for ER contributions than EE salary reduction

V. OTHER ISSUES

1. Nondiscrimination issues N/A
2. Funding Requirements
   a) Unfunded Section 457 plans
   b) Limits availability to certain EE groups
   c) Tax exempt NGO use Section 457 plans as top hat plans
3. Section 457 Plan Reporting and Disclosure
   a) Government ER exempt from ERISA
   b) Tax-exempt NGO: Satisfy ERISA directly or by DOL compliance method

VI. DEFERRED ARRANGEMENTS NOT CONSIDERED DEFERRED COMPENSATION PLANS

1. Vacation and sick leave
2. Compensatory time
3. Severance pay
4. Disability pay and death benefits

VII. DEFERRED COMPENSATION PLANS NOT SUBJECT TO SECTION 457

1. Non elective deferred compensation of non employees
   a) Plan must be uniform for all participants
   b) No variations or options
   c) Covers all EEs with same relationship to ER
2. Church deferred compensation plan (after 1986)
3. Judicial Deferred Compensation Plans if
   a) In continuous existence since 1979
   b) All eligible judges participate and contribute the same % of compensations
   c) No option affecting the amount of includible compensations
   d) Retirement benefits percentage of compensations
   e) Limits on benefits paid
4. Non government tax exempt employer deferred compensation plans
   a) Grandfather provisions may apply
   b) Pre-1987 deferred amounts exempted
   c) Post-1986 deferred amounts exempted if based on an written agreement stipulating deferrals of a fixed amount or fixed formula
5. Non elective government employer deferred compensation plans if
   a) Stipulate annual deferrals as a fixed amount or by fixed formula
   b) Post July 13, 1988 deferred amounts exempted until the tax year ending after the effective date of an agreement modifying the fixed amounts or fixed formula

6. Collectively bargained deferred compensation plans if
   a) Plan cover broad group of EEs
   b) Definite, fixed and uniform benefit structure
   c) Plan exists since 1988
   d) Loses grandfathered status if change benefit formula or expands class of participant
   e) Generally available to union EEs in a nonqualified, non elective plan

VIII. TAXATION OF NON-ELECTIVE DEFERRED COMPENSATION SUBJECT TO SECTION 457

1. Current taxation on amounts the taxpayer
   a) Has not yet received
   b) Has no current right to receive
   c) May not actually ever receive
2. Since private sector not subject to these rules, they are at a comparatively more advantageous hiring position